Towards a European Budgetary System

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Abstract

The present EU budget is inconsistent with the current state and future prospects of European integration. Three failures are most evident: first, spending is heavily tilted towards the support of a declining sector, agriculture; second, it is almost impossible to reallocate spending across time and across policies; and third, its size is unrelated with the goals of the Union. Transforming the Community budget into a means through which the economic policy of the Union is consistently defined and put into practice requires correcting these failures. This can be done by moving towards a fully fledged "European Budgetary System" in which the EU and national budgets pursue, in a co-ordinated manner, commonly-agreed objectives set in the Broad Economic Policy Guidelines. On a multi-annual basis, the EU Financial Perspectives and the national Stability and Convergence Programmes would be set within an aggregate European Stability Programme. Annually, this should give rise to a EU Budget Law to be approved alongside national budget laws.

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1. Introduction

As it stands today, the EU budget is an historical relic. Three failures are most evident. First, its spending composition is heavily tilted towards the support of a declining sector, agriculture; second, it is almost impossible to reallocate spending across time and across policies to reflect economic and political priorities; and third, its size bears no comparison to any of the budgets of EU countries and it is unrelated with the EU goals.

First, in terms of composition, the current EU budget still largely reflects a double deal: the EC-6's Common Market and the Single Act of 1985. The first deal entailed a large share of Community expenditure devoted to the Common Agricultural Policy (CAP) as a price to be paid for allowing Germany's industrial products to enter the French market. The second deal saw the rise of spending on cohesion and regional policies in the context of the Iberian enlargement as the price to be paid for compensating the possible losers of the 1992 Single Market project. Those two policies together represent some 85% of the EU budget. The remaining 15% is divided between third countries' policies (essentially development aid and growth-enhancing assistance), internal allocative policies (such as research, Trans-European networks, etc) and administrative expenditure. The EU does not finance a EU-wide welfare system and thus plays no role in explicit interpersonal redistribution. However, the CAP, which originally represented much of the allocative function of the EU budget, by moving away from price support towards direct aid, increasingly contributes interpersonal redistribution. Equally the EU budget has no role in macroeconomic stabilisation.

Second, the EU budget displays a degree of rigidity far exceeding that of national budgets both across time[1] and across budgetary headings. Both in the multi-annual programming and in the annual budgetary procedure, the transfer of money across budgetary headings is subject to cumbersome procedures, largely exceeding those at the national level.

Third, given its small size (1.05% of GDP in 2003), the EU budget has practically no macroeconomic relevance. National budgets, measured as the average of public spending, amounted in 2002 to 48% of GDP in the euro area and 47% of GDP in the EU as a whole. The smallest national budget – that of Ireland – is almost 36% of GDP. Moreover, its maximum size (1.27% of EU GNP) is predetermined by a 1992 political agreement confirmed in 1999 and has no relation with goals and objectives of the EU.

[1] Article 269 TEC constraints the EU budget to equilibrium in each and every budgetary year.

While highlighting these three failures, we do not deny two positive features of the EU budget compared to national budgets, namely simplicity and transparency. Nevertheless it is increasingly evident that the current EU budget is inconsistent with the present state and future prospects of European integration. While its historical and political roots are deep, the EU budget does not stand up to economic and political scrutiny: no federation (mature or not) around the world has a budget whose dominant share is devoted to supporting a declining sector, does not provide public goods typically featuring large economies of scale, and does not supply any stabilisation in case of idiosyncratic disturbances.

How can the weaknesses of the present institutional arrangements be tackled? This paper proposes to complement the current strides towards more effective *horizontal* coordination amongst national budgetary policies by *vertical* coordination between national and EU budgets. In our view, the EU should move towards a European Budgetary System in which both the national and the EU budget "play together". The issue of coordination between EU and national budgets is an area which the literature has left largely unexplored. At present, there is no coordination between the EU and national budgets, either on the spending or on the revenue side. This would allow the European Union in its broadest sense, which is the sum of the EU Member states and the EU Institutions, to devise a consistent approach to fiscal policy. This system does not require any change in the Stability and Growth Pact whose provisions would continue to hold for all EU countries.

The paper is organised as follows. Section 2 presents a conceptual framework for the allocation of tasks between the EU and the national budgets. Section 3 identifies the areas where EU spending should be re-oriented. Section 4 deals with the issue of flexibility in the EU budget. The following two sections tackle the issue of coordination between the EU budget and the national budgets. Section 5 put forward the idea of a European budgetary system, the main proposal of the paper. Section 6 spells out how it could work in practice. Section 7 concludes.

2. Re-thinking the EU budget: a conceptual framework

At present, the EU and national budgets are almost completely separated. EU spending is practically fixed both in terms of size and composition, with its ceiling and structure set every seven years in the so-called Financial Perspectives. National budget priorities are set largely disregarding EU programmes, with the exceptions of agriculture and cohesion where EU

intervention is sizeable. However, considerations on the relative effectiveness of EU and national spending are largely absent in determining how to carry out public policies. This is a source of inefficiency as it leads to lower-than-desirable provisions of public goods or higher-than-needed overall public spending.

For expository convenience, it is useful to think of any policy as a public good, Y, which is being produced through two inputs, national spending, G_N, and EU spending, G_{EU}[2]:

(1) $Y= f(G_N,G_{EU})$

G_N and G_{EU} are characterised by a specific productivity, α and β, respectively. α and β should not be seen as technical coefficients, but reflect a broad array of criteria identified in the fiscal federalism literature (see section 3).

The overall public spending plays the role of budget constraint and is indicated by G:

(2) $G = G_N + G_{EU}$

Figures 1 and 2 give a graphical representation of our model. The existing distribution of spending between the national and the EU level (E in both figures) most likely reflects political and institutional constraints. E is clearly a sub-optimal position. An optimising policy maker, controlling both G_N and G_{EU} would, given the total amount of resources, choose the sharing of the production between national and EU level of expenditure that maximises the production of public goods, or, for a desired level of output, choose the optimal sharing of spending between the EU and the national level that allows to minimise G. The sharing will be determined by the form of the production function f(.) and different productivity of the national and the EU expenditure.

In Figure 1, we assume $\beta>\alpha$. Hence, Y would be maximised for a given level of total spending if much of the financing would take place at the Union level. The opposite holds in Figure 2 where $\alpha>\beta$. An optimal allocation of spending between the EU and national budgets implies moving from E (reflecting the existing allocation between EU and national budgets) to either E^I (maximum Y) or E^{II} (minimum G)[3].

[2] For simplicity, in what follows G_N and G_{EU} are treated as a single value. However G_N should be thought of as a matrix (the spending items per line and the countries per column) and G_{EU} as a vector.

[3] While in Figures 1 and 2, we have an internal solution (i.e. a certain public good is produced optimally by a combination of EU and national spending), it cannot be excluded that efficiency is optimised by allocating spending on a certain public good totally at the EU or at the national level. This must be the case for a host of public services of purely national or local interest, see next section.

Figure 1: Higher productivity of EU spending: β>α

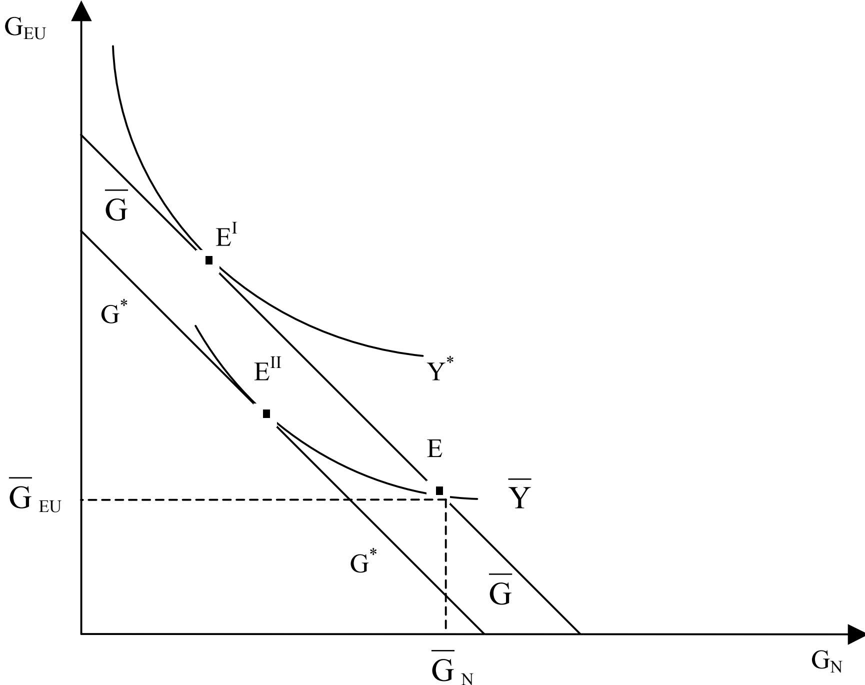
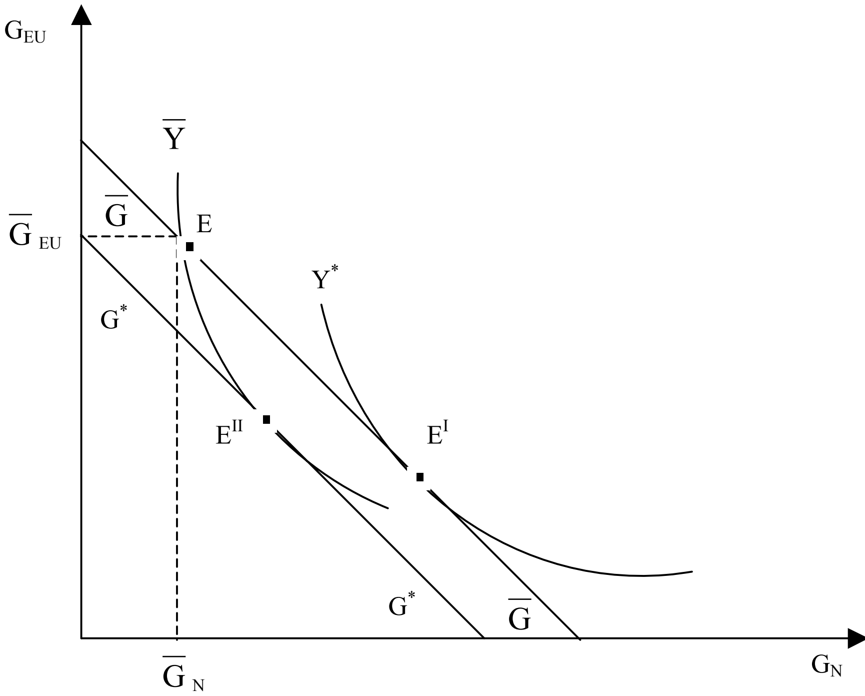


Figure 2: Higher productivity of national spending: α>β



Jumping directly from the current sharing of spending to the optimal sharing may prove unfeasible. In particular, the decision-making process as well as rivalries between institutions and levels of governance may hinder reaching the first best solution. Nonetheless, even a gradual move towards the optimal composition of spending would still improve efficiency[4].

In essence, in order to reform public spending in the EU economy, one has to pass a judgement on the desired level of output Y*, on what type of production function is relevant for the production of any given public good[5], on the relative value of α and β and, as we will argue below, a EU budgetary system should complement such an assessment with an overall budget constraint, G*, thereby overcoming separate, and by definition sub-optimal, constraints on G_N and G_{EU}.

The theory of fiscal federalism, to which we turn in the next section, sets out the guiding principles to assess the relative suitability of EU and national spending in supplying public goods.

3. What should the EU budget do?

3.1. The old and new theory of multi-level public finance: a bird's-eye view

Thinking of the future EU budgetary system raises the issue of the allocation of competencies between the Community and the Member States. The classic theory of fiscal federalism and new political economy of multi-level government set a number of criteria for deciding how to allocate competencies between the central EU level and Member States.

Classic fiscal federalism (e.g. Oates, 1999) emphasises the need to:

- *Internalise externalities*: if the positive effects of programmes on economic actors other than those financing them are not internalised, free riding will lead to an under-supply of such programmes;

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[4] One could model this process in a game theory setting in which EU institutions (Commission, Council, Parliament), optimising different objective functions, may engage in a non-cooperative (repeated) game.

[5] For instance, a linear production function associated with a linear budget constraint will deliver only corner solutions: that is policies which ought to be run totally either at the national level or at the EU level depending on which level the productivity is the greatest: under $\beta>\alpha$, Y would be maximised for a given level of total spending if the whole financing would take place at Union level, while the opposite holds if $\alpha>\beta$. In Annex 1, we developed a simple model based on the linear setting where we analyse the problem of spending allocation between the national and the EU level and we also take into account institutional or political constraints

- *Avoid internalities*: prevent beneficiaries of spending programmes from shifting their financing onto agents (usually taxpayers in the same or in other jurisdictions) who do not benefit from those programmes;
- *Exploit economies of scale*: increase in efficiency of supply arising from declining costs of production;
- *Attain minimum size*: small countries or jurisdictions do not attain the critical mass to provide the minimum amount of certain types of public goods;
- *Take into account heterogeneity of preferences*: in line with subsidiarity, when preferences between jurisdictions are heterogeneous, a decentralised provision of public goods is superior when compared with a uniform supply at the central level.

While fiscal federalism focuses on competencies, a parallel can be drawn between these and spending allocations.[6] The theory implies that the functions of two of the three of Musgraves' branches of government – that is income redistribution and cyclical stabilisation – should be carried out at a sufficiently high level of government. In the public finance area, the allocation function deals with the provision of public goods either as pure public goods (non-rival and non-excludible), quasi-collective goods or merit goods (Moesen, 2002). As shown by Alesina et al. (2001), there exists a trade off between the benefits of scale and the costs of heterogeneity: the EU should focus on policy areas where economies of scale and externalities are large, and delegate to national or lower-level governments the policy areas where heterogeneity of preferences is predominant relative to the benefits of scale.

Classic fiscal federalism is built on the assumption of a benevolent social planner. The new theory of fiscal federalism encompasses the political economy of the decision making process (see, e.g. Persson et al., 1996, Tabellini, 2002).

Three aspects are stressed. First, second-best considerations related to constraints in policy formation imply that the provision of a public good, at a level different from the optimal one, in the absence of such constraints, can still be welfare enhancing. Second, in order to foster political acceptability of provision of a certain programme, it may be necessary to compensate the losers. For instance, "giving something to everybody" may be inefficient (by entailing

[6] Clearly, the relation between competencies and spending is complex. Competencies allocated to the EU, disregarding whether exclusive or shared, may generate four types of spending: 1) only EU spending (e.g. CAP); 2) EU and national spending (e.g. Structural actions); 3) only national spending (e.g. environmental regulation); 4) no spending at all (e.g. competition policies).

"transfers churning"), but may enhance the political acceptability of redistribution.[7] Third, the fiscal federalism literature largely ignores decision-making costs (ex ante) and frustration costs (ex post) which are typical of large and heterogeneous groups.[8] The existence of such costs implies that the EU level should focus on medium-term or time-invariant priorities which do not require frequent re-negotiations.

Fiscal federalism, however, even if supplemented with the new political economy approach, does not encompass the EU political dimension of subsidiarity and proportionality enshrined in Article 5 TEU[9]. With reference to the model described in section 2, if $\alpha=\beta$, subsidiarity considerations would plead in favour of carrying out the project at national level. Also in case of uncertainty on the size of α and β, subsidiarity would imply that spending is carried out at the national level. In any event, the burden of proof should be with the higher level.

3.2. Re-orienting EU spending

Even to the layman, it is apparent that the current EU budget hardly conforms to the normative implications of the theory of fiscal federalism, even taking into account the political economy constraints stressed by the most recent literature.

As we argued in the introduction, the EU has a small central budget which is neither adequate in terms of composition to the new stage of economic and political integration, nor sufficiently flexible to adapt to changing circumstances and political priorities. Clearly, path dependency matters: it would be politically ingenuous to attempt to redesign the EU budget from scratch. Nonetheless, the contradictions of the current budget and, more broadly, the public finance arrangements within the EU (Community and Member States' budgets) are becoming increasingly apparent as integration deepens amongst a subset of countries (those sharing monetary sovereignty) in a Union that, with enlargement, becomes more heterogeneous.

[7] This applies also at the national level to the welfare state where the willingness of relatively well-off income earners to finance the social programmes has been eased by the fact that they themselves benefited from such programmes. See, Buti, Franco and Pench (1999).

[8] See Teutemann (1992). A possible political reaction could be the shift, in the case of certain public goods to clubs within the EU, making use of the "reinforced cooperation" procedure foreseen in the Nice Treaty.

[9] *"The Community shall act within the limits of the powers conferred upon it by this Treaty and of the objectives assigned to it therein. In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the member States and can therefore, by reason of scale or effects of the proposed action, be better achieved by the Community. Any action by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty."*

The discussion below is organised around the three Musgravian branches of government: allocation, redistribution and stabilisation.[10]

Expenditure for allocation

New EU public goods. In the enlarged Europe, defence, internal security and external aid will have to be increasingly supplied at the central level. These are textbook examples of public goods to be provided centrally. Protection against organised crime and terrorism, border patrols, immigration policy, and aid to third countries are characterised by large economies of scale, strong externalities, relatively homogeneous preferences, the need to attain a minimum size and the risk of free riding. Moreover, as stressed by Tabellini (2002) and Berglöf *et al.* (2003), coordinating national policies is not enough as all these areas concern the executive power of governments and are executed by specific bureaucracies. Central provisioning will also strengthen the bargaining position of Europe on the world scene.

As to defence, several of the above criteria apply, but heterogeneity of preferences (political neutrality) persists. In the past, provisioning at the EU level has encountered political resistance, explained by the fact that central provisioning implies "delegation" from national to European policymaking bodies of the authority to decide about the supply of "sovereign-sensitive" goods (Persson et al., 1996). To the extent that the EU moves towards political union, such reluctance should gradually be overcome. A solution could be to focus EU provisioning onto the relatively less controversial aspects of these policies (e.g. in defence, start with the Rapid Reaction Force) and dissociate direct participation from financing (all EU members would contribute to the financing via the EU budget, but the countries encountering political opposition would not be directly involved in execution).

Growth-enhancing expenditures. The liberalisation initiatives of the last decade have not translated into higher growth. The so-called Lisbon strategy is set to transform the static efficiency gains of the Single Market into dynamic efficiency gains. Several of the components of the strategy do not have budgetary implications or, when they do, are to be carried out at the national level. Nonetheless, some growth-enhancing policies with large

[10] The scope of the following discussion (and of the paper in general) is not to determine the values of α and β for any type of policy, but rather to show how competencies could be reorganised on the basis of the implicit values of α and β which have emerged from the most recent literature on fiscal federalism. Several of the issues discussed in this section were already dealt with at the beginning of the 1990s in the report *Stable Money, Sound Finances*, see European Commission (1993).

externalities could be carried out at the EU level. Examples of these are major R&D and innovation programmes and Trans-European Networks, especially along East-West axes.

Other internal policies. A larger heterogeneity of preferences in a wider Europe entails a strict application of the "subsidiarity test". Several existing spending programmes under the Internal Policies category do not pass this test. Future EU activities could focus on fostering citizens' Europe. Increased mobility across countries could be promoted by setting goals in education and language proficiency coupled with EU financing of minimum standards (von Hagen, 2002)[11].

Common Agricultural Policy[12]. The reduction in agricultural spending is the *conditio sine qua non* to claim a stronger role of the EU budget in other, more suitable areas. The CAP hardly complies with any of the criteria identified in Section 2 and can actually be taken as an example of optimisation of internalities with perverse redistribution effects. The shift away from price support towards direct aid (supporting farmers' revenue) needs to continue. However, direct aids amount to interpersonal redistribution of a specific class of citizens (workers in the agricultural sector): there is no justification to carry out these kinds of transfers via the EU budget. The need to sharply reduce the share of the EU budget devoted to agriculture to make room for other priorities has long been recognised (e.g. Padoa-Schioppa, 1987). Boldness requires going beyond a very mild erosion of the CAP share in the budget – as decided in the Brussels European Council in October 2002 - and addressing head-on the issue of a radical reform of the CAP, including its partial re-nationalisation (at least of direct aids).

Summing up. The conceptual framework laid out in section 2 allows us to summarise the challenges faced in re-thinking the attribution of allocative tasks between the EU and the national budgets. The approach put forward amounts to "endogeneise" the size of the EU budget so as to allow, in the steady state, to minimise the total amount of public spending (national plus EU) for a given level of output.

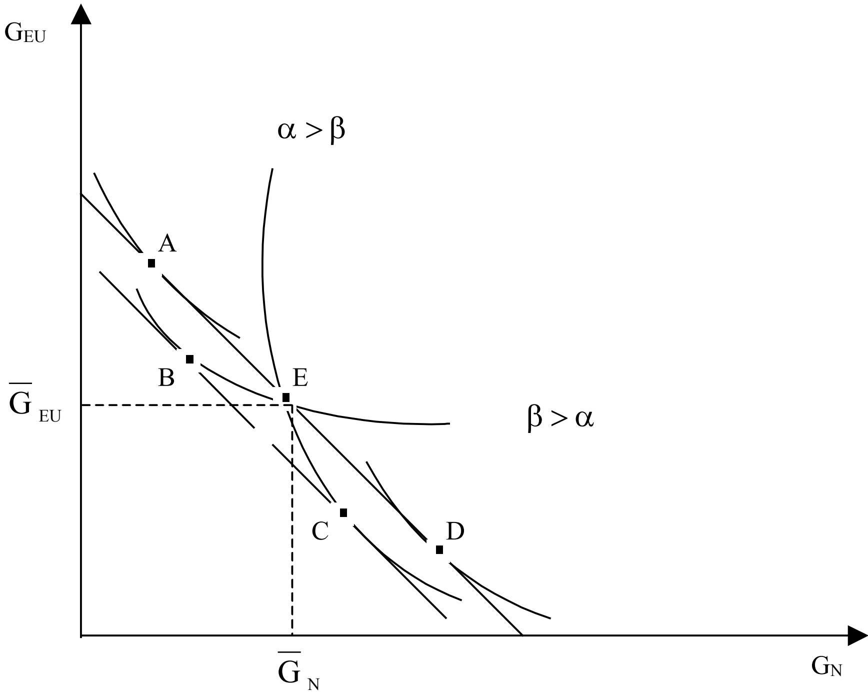
[11] As pointed out by von Hagen (2002), increasing mobility could be also seen as a way of lessening the costs of EMU.

[12] The nature of CAP as an allocative or redistributive policy is much disputed (see Nava 2000). As a redistributive policy, one of the many reasons why the CAP is widely criticised is due to the fact that its redistribution function depends more upon the work title (farmer or else), rather than the income of the beneficiary.

Figure 3 illustrates the overall budget constraint (EU plus national spending) as the 45° straight line. The production schedules are the curves[13] going through EB in the case of higher efficiency of EU spending and the line going through EC in the case of higher efficiency of national spending.

According to the analysis in the previous section, the CAP should move from E towards C, implying a gradual re-nationalisation of agricultural policy, coupled with, in perspective, a lower support to the sector (shift to a lower level of Y). External aid, defence and internal security would be shifted along the EA line, representing a move from national to EU financing and, for some of the items, entailing also an overall rise in public spending. In line with the EU growth strategy set out by the European Council of Lisbon in 2000, R&D, Trans-European Networks (TENs), European citizens' programmes (such as the Erasmus programme) and major innovation projects, would move from E towards B or A. Finally, most of the so-called "other internal policies" in the current EU budget covering a host of smaller programmes would probably have to shift from E to D or C.

Figure 3: From the current to the future allocation of spending



[13] For those policies where optimal production takes place fully at the national level or at the EU level, the outcome would be either a move towards total re-nationalisation or a move towards total centralisation at the EU level.

Redistribution and stabilisation

The perceived political resistance to any radical change appears particularly strong in the other two Musgravian functions of government: redistribution function and stabilisation function. Fiscal federalism suggests that income redistribution and cyclical stabilisation should be carried out at a sufficiently high level of government. However, in both cases, political constraints and social preferences make any substantial reallocation of functions between the EU and the national governments unlikely in the foreseeable future. Nonetheless, an increase in the effectiveness of these policies could be achieved within the current institutional setting.

Redistribution. Conceptually, cohesion policy could be implemented via three different funds, responding to different needs: 1) "Convergence Aid" funds: funds devoted to helping backward countries and regions to get catch up with richer countries by growing faster; 2) "Restructuring Aid" funds: funds intended to facilitate the restructuring of the internal market for those *entities* affected by a shock (e.g. technological change, globalisation, enlargement) of exogenous nature; and 3) "Interpersonal Redistribution" funds: funds tailored to top up the level of income of the poorest citizens.

So far, the bulk of EU involvement in redistribution has concentrated on convergence and restructuring. The interpersonal dimension, which is at the basis of the welfare state and the European Social Model has, up to now, remained within the remit of the national competencies. Should this focus be shifted in a Union with 25 members?

Interesting proposals for a direct EU involvement in interpersonal redistribution have been made. While the idea of a EU-wide minimum social safety net has its merits,[14] political constraints will most likely limit the main goal of the EU redistribution to policies for regional convergence. Keeping the focus on redistribution across countries or regions, rather than across citizens, means that reform of the redistribution policy will essentially concern the rules through which it is implemented. There are two directions for reform that have been repeatedly evoked in the ongoing debate on the future of structural policy: a) regional vs. country focus, and b) "money with strings attached" versus "block grants".

As for the first issue (geographical focus), several arguments have been put forward in the literature in favour of a shift from the current regional focus towards a country focus. First, efficiency may better be obtained by allocating money at the country level and letting the

country decide where to invest within the country, rather than the EU level deciding which regions within a country deserve investment support (an argument paying respect to the subsidiarity principle). Second, the current regional focus may result in treating unequally, because of different regional imbalances, countries with otherwise similar levels of wealth (de la Fuente, 2001). Third, EU cohesion and structural policy is only a part (often, relatively small) of the regional (or sectorial) policy pursued at the national level using domestic funds. Leaving to the countries, rather than to the regions, the task of using the EU funds would ensure greater coherence of the EU and national intervention. Moreover, it would avoid the perverse implication of subsidising those countries whose national regional policy are less effective.

The distinction between Convergence Aid and Restructuring Aid is important to assess the relevance of these arguments. All in all, a country focus appears preferable in the case of convergence aid. This would imply that countries (as opposed to regions) would decide on the use of funds. Assignment of funds could still take into account to any chosen degree regional imbalances within a country (by looking at both mean and dispersion of per-capita income). Instead, a regional or a sectoral focus still seems justified in the case of restructuring aid, except perhaps for small and very specialised countries.

As for the second issue (conditionality), one could balance several arguments in favour or against a shift from earmarked funds to block grants both in the case of Convergence Aid and in the case of Restructuring Aid. While the system of earmarked funds may seem cumbersome, it has three main advantages. First, from a political economy viewpoint, imposing conditions on the use of resources may reassure countries, which are net contributors to the EU budget. Second, the principles underlying EU structural policy are sound and, where they have been taken seriously, have contributed to improving the "quality" of public administration thereby entailing systemic effects going well beyond the direct impact of EU funds[15]. For instance, administrative and institutional reforms leading to a greater quality of public administration intriguingly contributed to the success of Ireland and Spain, compared to Italy in the last decade. Third, conditionality allowed developing a set of coherent multi-annual programs (the so-called Community Support Framework) which has proved useful in shielding investment expenditure from the economic cycle. These elements –

[14] See, Bertola (1999), Bertola et al. (2000), and Boeri and Terrell (2002).
[15] See, Mairate and Hall (2000) and Hallet (2002).

political acceptability, institution building, long-term investment plans - are likely to be even more important in a wider EU.

The true challenge for redistribution policy would be then to combine a country focus for Convergence Aid still maintaining the positive elements contained in a system of earmarked funds. A move towards block grants, at the country level, complemented by direct conditions on the quality of institutions and on the stability of investment plans, might be an innovative avenue that could be explored.

Stabilisation policy. EMU raises the issue of cyclical stabilisation in the event of asymmetric shocks. Federations around the world typically have a large central budget and stabilisers which automatically smooth idiosyncratic shocks. The EU fiscal rules have a different logic. They imply that stabilisation is carried out at the national level: countries should bring their budgets "close to balance or in surplus" in normal times so as to have sufficient room for manoeuvre to absorb negative shocks without infringing the 3% of GDP deficit limit[16]. The Commission has recently stressed the importance to assess the medium term deficits targets in structural, rather than nominal terms (European Commission, 2002b). This is consistent with the absence of centralised stabilisation.

While shock-absorption via national budgets will remain the norm in EMU, there is the question of risk sharing in the event of large idiosyncratic shocks. In such a case, a response by the EU budget could be welfare-enhancing. As either the setting of EU automatic stabilisers[17] or the possibility for the EU budget to run deficits or surpluses appear politically unfeasible, two options remain: an insurance instrument triggered by asymmetric disturbances (Italianer and Vanheukelen, 1993) or the possibility of raising funds in the market by the EU (extra-budget) and transferring them to the Member country hit by the shock. The first option could be accommodated by creating a single, but "universal" reserve which could be used for stabilisation as well as other purposes. Such a reserve could be mobilised by the Commission via automatic rules, without passing through a cumbersome procedure, and possibly replenishing the reserve during the year by unused commitments[18] [19]. An argument in favour

[16] See, Brunila, Buti and Franco (2001).
[17] For instance, von Hagen (2002) has suggested that minimum unemployment benefits for a limited period (say six months) could be paid by the EU. An idea along similar lines was first put forward in the Marjolin report in the 1970s (European Commission, 1975).
[18] As a precedent, for the first time in August 2002, following the flooding in Central Europe (especially the Czech Republic and Germany), the resources for the emergency funds have been taken from the unused commitments for the structural policy.

of the second option is the fact that large country-specific shocks are rare and thus such a facility would be seldom activated.

3.3. Re-orienting EU revenues

This paper deals mainly with the expenditure side of the EU budget. However, many of the shortcomings of EU spending affect, *mutatis mutandis*, the revenue side of the EU budget as well. Indeed, the issue of financing and expenditure cannot be separated from the issue of at which level to undertake such expenditure. As any expenditure should be financed in the most economically sound way according to the time horizon of the expenditure and of its effects on the economy, revenue and expenditure reforms should be carried out in parallel.

Both the European Commission and the academia have indicated that the current system of financing the EU budget is imperfect in several respects, namely, with respect to transparency and accountability vis-à-vis the EU citizens.[20] This leaves ample scope for a thorough reform. By 2006, some 80% of the EU budget will be financed by national contributions and only the remaining 20% by direct levies on citizens: the first issue in the debate is whether, in both economic and political terms, this balance is the correct one._

Another issue relates to progressivity vs. proportionality of the EU budget. If block grants are introduced, then progressivity of the revenue side of the EU budget could also be explored. Indeed, if unconditional transfers are paid out to a set of countries for convergence purpose, one could also argue that the same result is obtainable by making the same set of countries paying less to the EU budget: that is equivalent to having a revenue side of the EU budget levying progressive taxes rather than proportional ones as today. It is to be noticed that progressivity is compatible with both a system of national contributions and of citizens' taxes.

4. Increasing the flexibility of the EU budget

Looking at the EU budget in an historic perspective one observes, at the end of the 1980s, a change in the regularity of revenues and expenditure. Since 1988, the "budgetary peace" between the Commission, the Council and the European Parliament, the three institutions

[19] However, the literature has pointed out that, even leaving aside political and moral hazard constraints, constructing such an automatic mechanism is not easy. See, e.g. von Hagen and Hammond (1996).
[20] See European Commission (2002c), section 1.4., Goulard and Nava (2002) and Tabellini (2002).

involved in the EU budget procedure, increased markedly[21]. This improvement in stability has gone hand in hand, however, with a reduction in the flexibility of the EU budget and an increase of the complexity of the rules governing it.[22]

There is a clear and well-understood trade off between resources stability and financial peace, on the one hand, and margin of manoeuvre or flexibility, on the other hand. In 1988, with the adoption of the so-called Delors I package, which instituted the first Financial Perspectives (FP), a political choice had been made in favour of the former. The FP set every seven years the ceilings for all budgetary headings and for certain subheadings. Member States have historically displayed stiff reluctance to modify the FP thereby hampering the shift of resources across years and headings. At present, moving unused resources, even within the annual budgetary procedure, from one to the other budgetary heading (or even sub-heading), is difficult if not impossible altogether.

In the medium to long run, both the EU budget and the national budgets have to respect similar constraints in terms of deficits. The EU budget is subject to the strict requirement of equilibrium laid down in Art. 269 TEC[23], while national budgets are subject to the medium term target of "close to balance or in surplus" of the Stability and Growth Pact. The difference between the two conditions boils down to the fact that the EU budget must always be balanced in each and every year, while national budgets have to be broadly balanced over the cycle thus allowing for deficits to appear in recession years and surpluses in boom years.

While the FP have helped ensure an orderly development of budgetary expenditure of the EU budget and guaranteed budgetary peace for the EU, it is increasingly evident that the current degree of flexibility is not compatible with the functions of a modern budget and does not permit the EU budget to react timely to changing circumstances. A higher flexibility is a pre-condition to move to a truly European Budgetary System, as proposed below.

A political choice in favour of stability at the expense of flexibility is not dissimilar from the one characterising EMU. In the run up to and in the early years of EMU, the trade-off between stability and flexibility of national finances was firmly resolved in favour of the former. Recently, however the Commission has moved in the direction of taking account of flexibility (European Commission, 2002b) by accepting that countries with sound public

[21] Since 1988 the EU budget has always been adopted on time and complaints to the Court of Justice by one or the other Institutions have nearly disappeared. In the period 1975-1988, preceding the FP, the adoption of the EU budget was delayed in 6 years out of 13 and the EU institutions complaint to the Court of Justice on 3 occasions.
[22] For a lucid overview of the issue of flexibility in the EU Budget, see Montagnon (2002).

finances (i.e. low stock of public debt, low implicit liabilities) could run small structural deficits without violating the requirements of the Pact. There is some ground to argue that a similar move should be undertaken in the EU finances.

5. Designing a "European Budgetary System"

Rethinking the EU budgetary arrangements goes beyond rethinking at which level individual policies should be carried out and how to conduct an EU fiscal policy under the straitjacket of excessive rigidity and small and predetermined size. The basic tenet of this paper is that introducing vertical coordination between the EU and national budgets can help to address the fiscal failures identified above.

So far, the EU and national levels have remained separate. As exemplified in the top part of Figure 4, fiscal policy in the EU is the outcome of two non-coordinated sets of instruments: on the one hand the EU budget and on the other hand the individual national budgets of the 15 Member States[24].

However, as the EU moves towards stronger co-ordination of national budgetary policies, such separation needs to be overcome. This has potentially profound implications for both the annual budget and the multi-annual FP.

The bottom part of Figure 4 shows how a coherent EU budgetary system, which puts the EU budget in line with the national budgets could be articulated. The EU budget is to be looked at as centralised (at EU level) fiscal policy subject to decentralised national constraints (EU budgetary resources are essentially Member States' contributions). National budgets are to be looked at as a decentralised system of fiscal policy subject to centralised EU constraints (the Stability and Growth Pact and the Broad Economic Policy Guidelines, BEPGs).

In a medium term framework (covering a time span of, say, five years), EU policy makers should elaborate an aggregate European Stability Programme which sets the spending priorities for the Union and the Member States[25]. It would also decide how to allocate

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[23] The European Convention seems oriented to respect both the spirit and the letter of this article (see Art. 39 of European Convention, 2002).

[24] According to the Presidency Conclusions of the Copenhagen European Council, 12th-13th of December 2002, the EU members are set to become 25 from May 1st, 2004, and 27 from the year 2007.

[25] This paper focuses on allocative policies. A proposal for a budgetary coordination mechanism putting the emphasis on stabilisation was submitted by the then French Finance Minister, Dominique Strauss-Khan, at the informal Ecofin Council in Dresden in April 1999. The French proposal stressed that the aggregate policy stance

spending on individual items between the EU and the Member States. The national Stability Programmes and a new EU-level Stability Programme – which would replace the current FP - would translate the common objectives into concrete medium term spending programmes. The provisions of the Stability and Growth Pact – namely the medium term target of "close to balance or in surplus" and the 3% of GDP deficit ceiling – will continue to apply to all EU countries.

The aggregate Stability Programme as well as its national and EU components would be rolled over and updated annually. This would mark a fundamental change compared to the existing situation where each national stability programme is decided on an individual basis (although on the basis of commonly-agreed assumptions) and the FP are set every seven years and are fixed within such a period.

A similar process would take place on an annual basis. The EU budget and national budgets should form a coherent set, adhering to the strategic objectives of the BEPGs (see Table 1 on the links between the BEPGs and the EU budget). It goes without saying that, given the relatively high decision-making costs, at the EU level, the annual process would mainly focus on fine tuning multi-annual priorities.

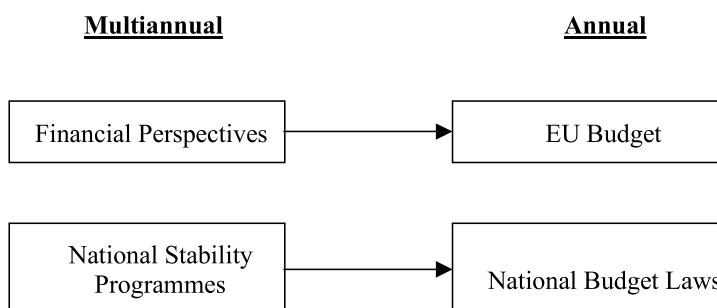
The upshot is that Member States and EU institutions would decide together how to translate their common policy priorities into global budgetary commitments and how these commitments are shared between the national and the EU levels. This implies building vertical links between the EU and the national budgets. Clearly, fiscal discipline will need to be upheld: the reconsideration of the distribution across jurisdictions should not imply an overall increase in spending. In the past, the stress on the contradiction between (Maastricht-induced) national prudence and alleged EU "largesse" has underpinned the refusal to reconsider EU budgetary responsibilities. However, as we move towards a EU budgetary system, such reluctance should be overcome. Such reassessment would not necessarily imply a substantial rise in the EU budget. As we pointed out in section 3, a rise in spending in certain areas would go hand in hand with a reduction in others. What this new approach would bring is a better efficiency: to the extent that the existing distribution of spending

at the EMU level must be examined on the basis of an aggregate stability programme. The proposal pointed out that the objective to achieve an adequate policy stance for the EMU as a whole should be taken into account when examining the national stability programmes. For a discussion, see Buti et al. (2003). A similar proposal has been presented recently by the vice-president of the EU Convention, Giuliano Amato, see Amato (2002). On similar lines, see Collignon (2002) and Majocchi (2002).

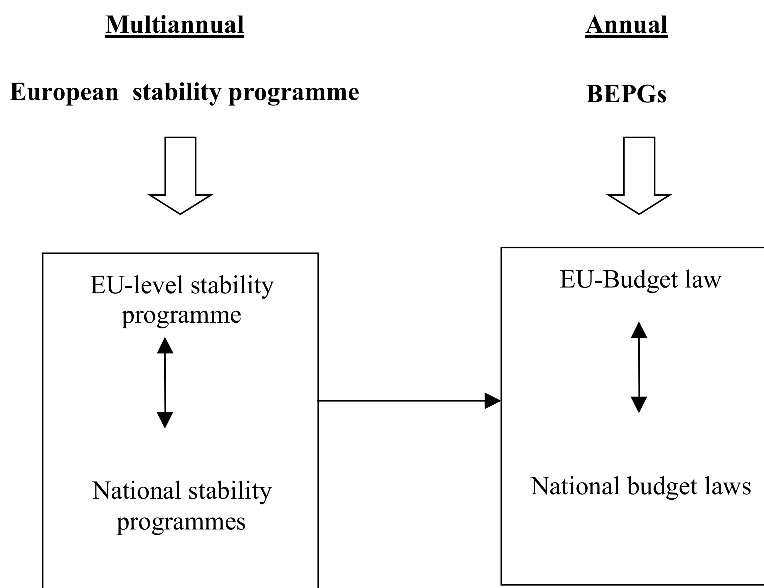
between the national and the EU level is not optimal, the net effect would be a decrease in overall public expenditure.[26]

Figure 4 Towards a European Budgetary System

Current Budgetary Processes



Future Budgetary Process



[26] We show in Annex, that, under certain circumstances, the current budgetary arrangements imply a higher overall spending and a lower supply of public goods than what would be implied by the optimal allocation of spending between the two levels of government.

Table 1: The BEPGs and the EU budget

	Priority BEPG 2002	*Budget item (B-2002, adopted by the EP on 13/12/01)*
1	Accelerate reforms in the network industries	B2-7 (Transport) B5-7 (Trans-European Networks)
2	Promote the quality of public expenditure by redirecting funds towards physical capital	B2-1-0 (Structural Funds: Objective 1)
3	Enhance environmental sustainability	B4-3 (Environment) B6 (Research and technological Development)
4	Investments in human capital, R&D and ICT	B2-1-2 (Structural Funds: Objective 3) B6 (Research and technological Development)
5	Active labour market policies and lifelong learning	B2-1-2 (Structural Funds: Objective 3) B3-1 (Education, vocational training and youth) B3-4 (Social dimension and Employment) B5-3-2 (Internal Market: Promotion of growth and employment: measures to assist firms) B5-5 (Labour market and technological innovation);
6	Encourage entrepreneurship by improving access to finance especially for SMEs	B5-5 (Labour market and technological innovation)

A couple of examples would help clarify this general statement. In Johannesburg, Heads of State and Government have agreed to pledge 0.7% of each country's GDP for development aid. The higher potential effectiveness of a centralised management of these resources calls for the assignment of such intervention prevalently at the EU level. The Lisbon growth strategy sets a target of investing 3% of EU GDP in R&D in order to foster competitiveness. Criteria of efficiency and effectiveness should orientate the split of this target between private and public spending, and, within the latter, between national level and the EU level. It makes

sense, for instance, to carry out large research and innovation projects directly at the EU level.

The 2001 BEPGs showed an opening in this direction: "Just like the Member States, the Community should apply strict budgetary discipline. This must be applied to all categories of the Financial perspectives, while respecting the interinstitutional agreement on budget discipline **and the improvement of the budget procedure; a flexible allocation of Community resources should be exploited in order to enhance the economic impact of the EU Budget**".(emphasis added). The Commission Communication on economic policy coordination of February 2001 (European Commission, 2001) states that "the establishment of guidelines and priorities in the EU budget should be embedded in a global vision encompassing both the guidelines and priorities in the budgets of the Member States and the criteria established in the Broad Economic Policy Guidelines in order to enable Member States to take them into account in their budget laws".[27]

6. A "EU Budget Law"

Consistently with the European Stability Programme, the annual EU budget should become a true "EU Budget Law". In order to achieve this aim, the current budgetary procedure (budget proposal, approval and implementation) would have to be overhauled.[28] Overhauling would be possible only if a balance of "sticks and carrots" is found to avoid conflicts among the Commission, the Council and the European Parliament (the last two being the two arms of the EU "budgetary authority").

[27] An even more ambitious objective would be to discuss, when establishing the priorities in the EU budget, also those policies, which have little financial impact for the EU budget, but a great financial impact on national budgets (ex. Community fiscal directives, environmental directives, etc). This would allow national policy-makers to take account of community inputs and embody them into their national policies. Von Hagen (2002) strongly supports the view of making "law making" compatible with "money spending" and more generally of assessing the financial impact, for the EU system, of "law making".

[28] The draft skeleton for the European Constitution (European convention 2002) has an article (Art. 40) specifically dealing with budgetary procedure for the EU budget adoption.

Table 2 spells out the differences between the current budgetary procedure and our proposal.

Table 2: PROPOSAL VS. CURRENT SITUATION

<table>
<tr><th></th><th>Phase 0:
Once every 7 years</th><th>Phase 1:
1 January to 30 April year T</th><th colspan="2">Phase 2:
1 May to 31 December year T</th><th>Phase 3:
Year T+1</th></tr>
<tr><td>CURRENT PROCEDURE</td><td>The Council, acting on a Commission's proposal and subject to majority in the EP adopts the Financial Perspectives</td><td>Commission Internal technical hearings</td><td colspan="2">First and Second reading of the Commission's Draft Budget by the EP and the Council. No role for the Commission as a College.</td><td>1) Commission executes Budget
2) Commission gives administrative report for year T-1 (compte de gestion) in April and political report (Allocated expenditure report) in July. There is no institutional discussion on either.
3) Commission proposes to EP and Council the mobilisation of unused resources.</td></tr>
<tr><td>OUTPUT</td><td>Multi-annual planning</td><td>Commission's Budget proposal</td><td colspan="2">Parliament Budget Adoption</td><td>Commission's implementation and reporting</td></tr>
<tr><td rowspan="2">NEW PROPOSAL</td><td rowspan="2">Co-decision between EP and Council for the adoption of the Financial Perspectives</td><td rowspan="2">1) Commission's presentation to the Jumbo Council
2) Commissioners' presentations to specialised Councils</td><td>I Reading:
May-Sep</td><td>II Reading:
Oct-Dec</td><td rowspan="2">1) Commission and member States executes budget
2) Commission is charged with the March and September reporting for budget of year T-1 and year T. (in parallel with MS's reporting).
3) BEPG implementation report extended to the EU budget (policy-by-policy).
4) Commission responsible for mobilising a universal reserve and unused resources</td></tr>
<tr><td>1) Commission ensures consistency between EU and national budgets
2) Commission active in Council and EP Budget discussion</td><td>Council and EP Second reading</td></tr>
<tr><td>OUTPUT</td><td>Multi-annual planning</td><td>Commission's Budget proposal</td><td colspan="2">Parliament Budget Adoption</td><td>Commission's implementation and reporting</td></tr>
</table>

Phase 0: Multi-annual planning

Currently, the Council, acting on a proposal from the Commission and subject to the majority approval in the European Parliament, fixes the FP which are then enshrined in the Inter Institutional Agreement. The FP establish the maximum expenditure per annum, per budgetary heading and in certain cases per budgetary sub-heading (e.g. Cohesion and structural funds within the Structural action heading).

In its second Communication to the Convention (European Commission, 2002c), the Commission has proposed that FP are adopted in co-decision between the Council and the European Parliament and that "(t)he Convention will have to look into the question of associating the national parliaments in this decision". This goes in the direction we suggest. The multi-annual planning of the EU should be in tune with national planning. Instead of being fixed for seven years, the FP would be rolling and linked with the BEPGs within a European Stability Programme.

Phase 1: Budget proposal

Currently, this phase covers Internal (to the Commission) Budgetary Hearings. The Commission makes the arbitrages of the expenditure claims across its own departments while making sure that FP are respected. Before completing the draft budget the Council, Commission and Parliament hold a trilogue. By the end of April, the Commission submits the draft budget for the following year to the Budgetary Authority (Council and Parliament).

According to our proposal, the current budgetary hearings phase should be "de-technicised" and "opened to the outside". This phase could become a political phase in tune with the debate taking place at the national level.

The Commission would present (end January/early February), at a Jumbo Council (Ecofin plus Budget Councils) and the European Parliament, its budgetary proposal for the following year and listen to national priorities and to the national intentions for the different policies[29]. Budgetary hearings cease to be only internal, but become external, and more political, in order to coordinate EU budget and national political priorities. Following the Jumbo Council, individual Commissioners would go to specialised Councils to present the Commission's budget proposals. Commissioners and national ministers would check the coherence of their

[29] If the more ambitious approach mentioned in the previous footnote is chosen, the Commission may also be expected to discuss those regulatory policies that have an impact on national budgets.

strategies – in line with the BEPG – and undertake to modify the initial proposal to achieve an overall consistent policy.

The Commission remains the *last authority* in the drafting phase and, as such, must ensure consistency between EU budget and national budgets. The Council and the European Parliament, however, would get involved in a phase where their role is, so far, null.

Phase 2: Budget approval

Currently, the Council and European Parliament, in their capacity of budgetary authority, go through the first reading of the Budget (approximately by September) and the second reading (between September and December). The Parliament finally adopts the Budget in December. There is no formal role for the Commission during this phase.[30] This has facilitated the task of several lobbies attempting to influence the Parliament's *rapporteurs* to modify the appropriations of specific budget lines, with the result, in most cases, of increasing the proliferation of small programmes, entailing a misallocation of resources and reducing the overall coherence of the budget.

In our proposal, while the Council and the European Parliament would remain *the last authorities,* the Commission would play an active role, in particular making sure that, during the first and second readings, the consistency between the EU and the national budgets is maintained.

Phase 3: Budget implementation and reporting

At present article 274 lays down that "(t)he Commission executes the Budget under its own responsibility". This has been criticised namely because, in economic terms, it does not always seem justified and in political terms it seems at odds with subsidiarity. If convergence policy would be implemented via (conditional) block grants rather than the current earmarked funds, this legal provision would need to be changed in favour of joint responsibility of the Commission and the member states in executing the budget. Currently, the Commission implements the budget, but has a limited autonomous political role to play, even in the event of re-allocation of the under-spending.

In our proposal, a parallel between the Commission and the EU Member States would need also to be established in terms of reporting. Currently Member States make their notifications

[30] However, on average the changes with respect to the draft budget are minute (often less than 1% of the total budget, in 2003 0.32%).

known in March of each year (for the budget implementation of the previous year) and in September (for the budget implementation of the same year). A similar reporting should be established for the EU budget and an overall report should be sent to the Council and the European Parliament. Going beyond the purely financial dimension, the Implementation Report of the BEPG issued every February should be extended to the EU budget and policies. Finally, a critical issue is that of the mobilisation of unused resources, in co-ordination with programmes and priorities of Member States.

7. Conclusions

Due to its small size, historically-determined rather than priority-oriented composition and lack of flexibility, the EU budget plays a modest role in the economic policy of the EU and the euro area. This translates into the fact that, at the central level, the EU is left, *de facto*, without one of the most powerful instruments of economic governance, the budget.

The basic tenet of this paper is that, as the European Union moves towards a higher level of integration, it needs a more consistent system of public finances which encompasses both national and EU budgets. We propose to move towards a truly European budgetary system where EU and national budgetary processes are closely aligned and an effective vertical coordination occurs in areas of common intervention. Implementation of this proposal would not require any change in the provisions of the Stability and Growth Pact. "Endogenising" the amount of public spending carried out at the EU level would help reduce the political controversies surrounding the size of the EU budget.

The focus of this paper was on policies pursuing allocative objectives, where there seems to be more political momentum for change. While we have only marginally touched upon the other two branches of government – redistribution and stabilisation – we believe that moving to such a system would facilitate improved efficiency and effectiveness of fiscal policies in these areas.

The main objective of this proposal is to put the EU budget in the policy coordination game of EMU. Its aim is to widen the role of the EU budget to make it an instrument of co-ordination of policies with the view to attain, eventually, a budgetary arm gradually emerging alongside the single monetary policy. In short, it is a step towards EU's economic governance where the community and national levels play together. The role of the EU budget would be valorised *in*

crescendo with EMU's fiscal surveillance which is currently being extended from "below the line" (budget balances) to "above the line" (single items of expenditure and revenues), with a growing emphasis on the quality of public finances, European Commission (2000, 2002a).

It goes without saying that several aspects of the proposed system and its functioning need further reflection. For instance, it remains to be seen whether the aggregate stability programme and, *a fortiori*, the EU-level stability programme, should encompass non-euro area countries. Second, in order to make this proposal viable, one should study how to contain the transaction costs involved by the horizontal and vertical coordination processes. Third, in order to function effectively, the system would require some synchronisation of budgetary procedures at the different levels of government (including regional ones in some Member States). An interesting idea initially put forward by Jacques Delors (see Pisani-Ferry and Jacquet, 2001) is to separate the budgetary calendar between a first 'EU semester', in which EU priorities would be accepted, and a 'national semester', in which such priorities are tailored to the national level. These and other issues deserve further scrutiny.

ANNEX: THE DISTRIBUTION OF SPENDING BETWEEN NATIONAL AND EU BUDGET UNDER POLITICAL CONSTRAINTS: A SIMPLE MODEL

In the present circumstances, the decisions on how to allocate spending between national and EU budget are completely separated. Given the current institutional constraints, EU spending is practically fixed. At the national level, fiscal discipline and political economy constraints make it costly to depart from the existing level of public spending.

In order to model the financing of a desired level of public good or service, we assume a linear "production function":

$$(1) \qquad Y = \alpha G_N + \beta G_{EU}$$

Where G_N is national spending, G_{EU} is community spending and α and β are their respective productivity.

As pointed out in the text, such a production function gives rise to corner solutions: if spending can be freely allocated between the EU and the national level, the whole financing would take place either at EU level (if $\beta>\alpha$) or at the national level (if $\beta<\alpha$). We assume however that political or institutional constraints make it costly to move away from some EU and national spending levels (indicated below by $\overline{G}_N$ and $\overline{G}_{EU}$) which are dictated by political/institutional constraints.

In order to capture these constraints, we assume the following loss function:

$$(5) \; L = (Y - Y^*)^2 + \theta(G_N - \overline{G}_N)^2 + \lambda(G_{EU} - \overline{G}_{EU})^2$$

Where Y^* is the desired level of output.

Minimising (5) with respect to G_N and G_{EU} yields:

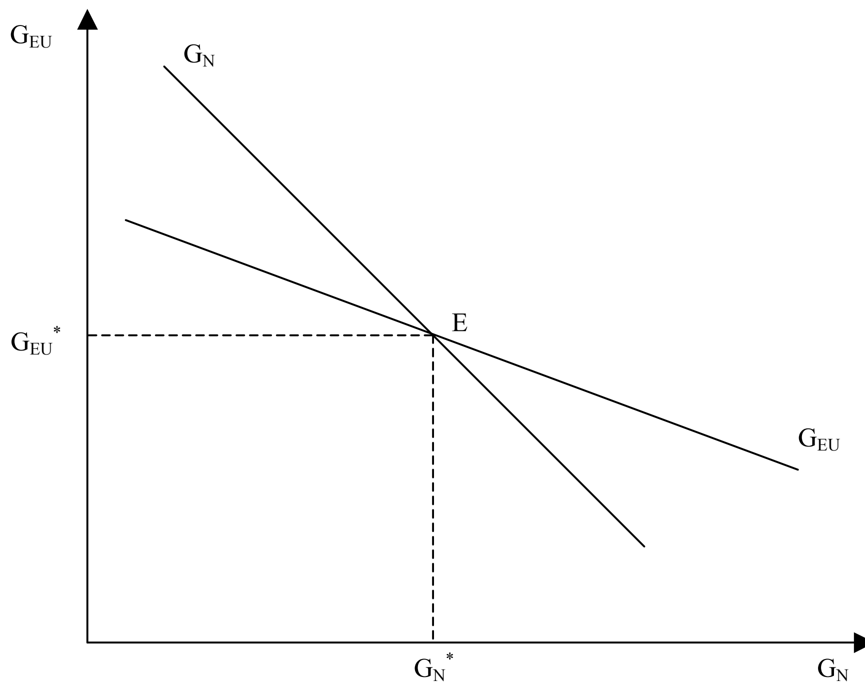
$$(6) \; G_N^* = \frac{\theta(\beta^2 + \lambda)\overline{G}_N - \lambda\alpha\beta\overline{G}_{EU} + \lambda\alpha Y^*}{\lambda\alpha^2 + \theta(\beta^2 + \lambda)}$$

$$(7)\ G_{EU}^{*} = \frac{\lambda(\alpha^2+\theta)\overline{G}_{EU} - \alpha\beta\theta\overline{G}_N + \beta\theta Y^*}{\lambda\alpha^2+\theta(\beta^2+\lambda)}$$

The relationship between G_N and G_{EU} is represented in Figure A.1. A fall in $\overline{G}_N$, leads to a rise in G_{EU} and a higher Y^* implies a rise in both spending. A fall in λ leads to a rise in both G_{EU} and G_N.

As expected, a higher and more productive EU spending leads to a lower national spending[31].

Figure A1 EU and national spending under political constraints



One can take the current situation as implying very high values of λ, implying that $G_{EU} = \overline{G}_{EU}$.[32] If the EU moves to a truly "budgetary system", the constraints on G_N and G_{EU} will be lifted and the choice of financing will depend on the relative efficiency of each type of

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[31] However, the resulting level of output will correspond to the desired level only if $\overline{Y} = Y^*$, where $\overline{Y} = \alpha\overline{G}_N + \beta\overline{G}_{EU}$.

[32] If so, the level of national spending becomes: $(8)\ G_N^* = \frac{\alpha Y^* + \theta\overline{G}_N - \alpha\beta\overline{G}_{EU}}{\alpha^2+\theta}$

spending. Nevertheless, in the transition, the existing constraints may still play a role. The transition can be thought of as a gradual reduction in the value of λ and θ, with the former which is very high today, coming down at a higher pace, together with a departure from the initial objectives of G_{EU} and G_N.

For analytical convenience, it is useful to take as a benchmark the case in which the desired level of output is equal or higher than that produced by allocating the total desired level of spending to the most efficient level of government. Formally: $Y^* \geq \alpha\overline{G}$ if $\alpha>\beta$ or $Y^* \geq \beta\overline{G}$ if $\alpha<\beta$.

Under such an assumption, and assuming that the current level of Y is lower than Y^*, it is easy to show that the current total level of spending is larger and the output is lower than the final equilibrium. Under $\alpha<\beta$ this occurs because, in order to shift Y towards Y*, G_N is set higher than $\overline{G}_N$ even though it is less productive than G_{EU}. On the contrary, $\alpha>\beta$, the desired increase in G_N is not compensated by a corresponding reduction in G_{EU}. As pictured in Figures A.2 and A.3 (under the case of $Y^*= \beta G_{EU}$ and $Y^*=\alpha G_N$, respectively), the offsetting reduction in the least productive spending only takes place over time as the constraints on λ and θ are reduced. In the final equilibrium, the desired level of output is wholly financed via the most efficient spending.

Figure A2: More efficient EU spending

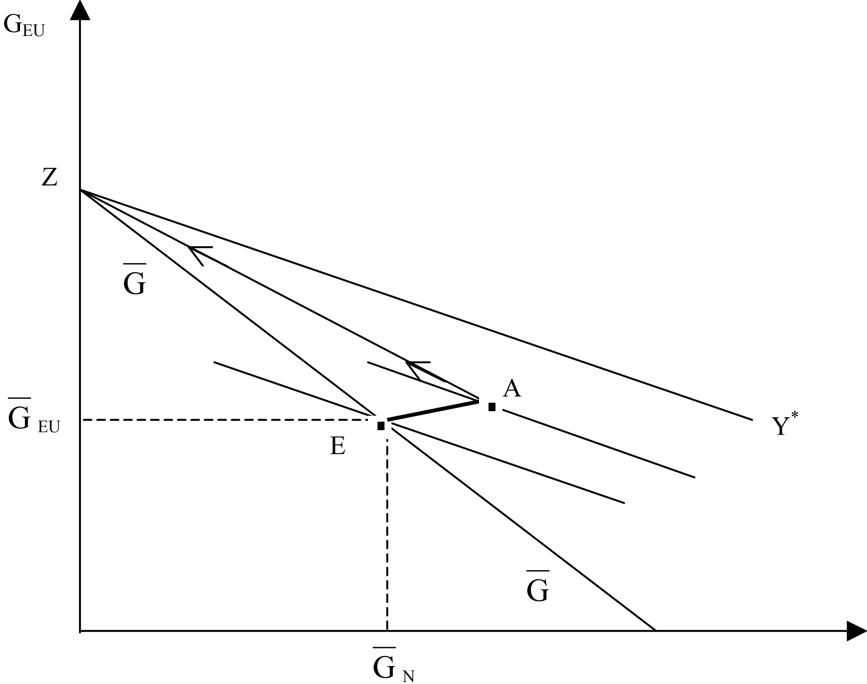
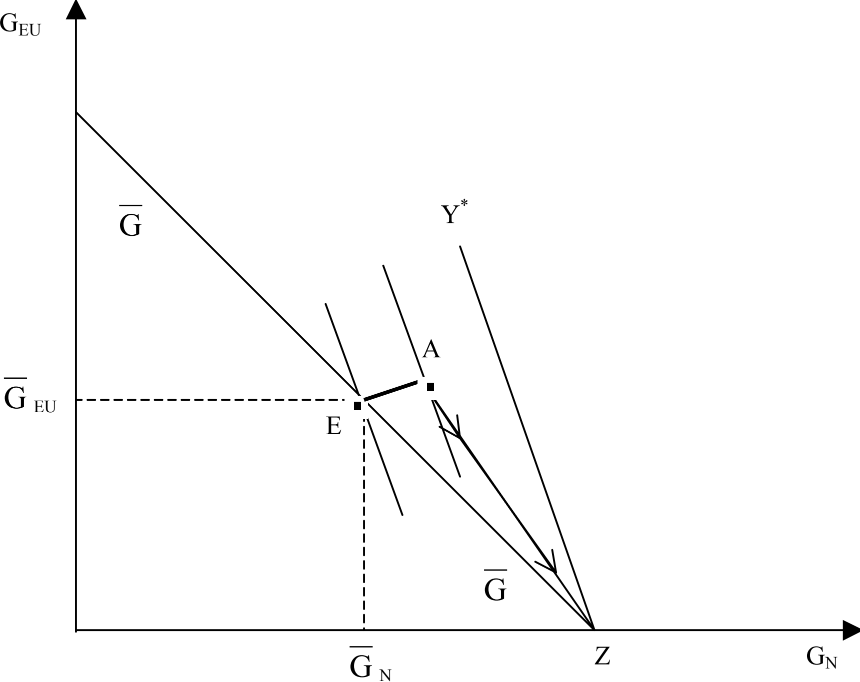


Figure A3: More efficient national spending



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